PROPORTIONATE LIABILITY

AND

CANADIAN AUDITORS

THE HON. W.Z. ESTEY, Q.C.

EXTRACT FROM

BRIEF PREPARED FOR
LEGAL LIABILITY TASK FORCE
CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

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I. EXECUTIVE SUMMARY: THE AUDIT EMERGENCY

The office and function of the auditor in this world of corporate and unincorporated group governance, as it exists in the 20th/21st century, is of preeminent importance.

Anything which threatens the availability of the competent, impartial, and independent audit, on an economic basis, is a threat to the integrity of the industrial/commercial/financial complex and to the community itself.

There are many devastating forces abroad which threaten the continued existence of the auditor as we know that institution. The most serious of those forces is the yardstick of legal liability for the auditor's negligence, "joint and several liability." This technical term of law simply means that the auditor is exposed to the risk for the payment of 100% of all the claimant's losses where, on the facts of the case, only 1% of those losses may actually have been suffered by reason of the fault of the auditor. The other 99% in such an example would consist of the damages caused by all the other defendants in the action, who may be, and frequently are, insolvent, or in relation to the judgment damages, impecunious.

A second contributing factor in this auditor's liability crisis arises out of the very nature of the audit function and the reporting process in the regime of the corporate audit and special audit reporting functions in the course of complex corporate procedures relating to insolvency or to merger, acquisition and corporate reorganization transactions. Many defendants are invariably involved in litigation related to these corporate financial proceedings. The scale of such transactions is generally very large. The damages assessed by the courts against all the defendants participating in these procedures is on the same large scale.

Adding "joint and several liability" for all participating defendants leads to the almost automatic result that the defendants capable of paying (such as the auditors) bear the heavy consequence of these judgments. Judgments on this scale lead inexorably to the destruction of the audit firm and of the partners individually. This is not a theoretical proposition. Recovery from auditors and others, of losses arising out of such transactions involving the auditors amongst other defendants, has exceeded, in one combination of settlements and judgments in Canada, damages of $125 million (mostly borne by the auditors.) Outstanding court actions or threatened claims in respect of this type of action in Canada are now well in excess of $3 billion. The United States experience, which we are prone to follow in close succession, is even worse.

The alternative to joint and several liability is the principle of proportionate liability for the auditor and the other defendants in the action according to their individual degree of fault as determined by the court. This is the essence of our plea.

The continued existence of a competent audit profession depends on the availability of adequate liability insurance at a reasonable cost. This resource is already in seriously short supply and the cost of this insurance coverage is increasing exponentially. In fact, the major auditing firms in Canada and around the world today are essentially self-insured.

The auditor does not here ask for exoneration from fault for his or her wrongs. Under the proportionate liability principle, the individual auditor shall remain liable and responsible for damage or loss actually incurred by reason of the individual auditor's negligence. The assets of the audit firm shall likewise continue to be exposed to the payment of loss actually occasioned by reason of the individual negligence of the partner in question.

Legislative action, at both levels in our federal system, is required. The judicial system can do nothing to alleviate the problem. The responsibility therefore falls upon Parliament and the provincial legislatures to revise the law now applicable to the payment of damages by defendants in this type of action.

We have seen the situation which has developed in this country, in the United States, and elsewhere. Though there may be a time delay before the full impact is felt in Canada, it is reasonable for Canadians to anticipate the same developments in this field which we have witnessed to date in the United States. Action should be contemplated in advance of the impact here so as to minimize the adverse results experienced in Canada when new practices and procedures are introduced here (usually from the United States) without the necessary forerunner of adjustments to our legal institutions.

Legislative action to address this problem has already been taken by the United States Congress and is being seriously considered in both Australia and the United Kingdom.

We believe that proportionate liability should be substituted for joint and several liability in a very limited, discrete area of the law. There should be proportionate liability in all claims against auditors, management, and others for losses arising from defective financial statements and other financial information relating to federal and provincial organizations. We believe that the auditor should have no liability, beyond his or her proportionate responsibility, for any such loss. This is particularly so in the case of business failures where the auditor has become the virtual insurer of all the defendants in legal actions arising from such failures.

We now propose that the following amendment be enacted for organizations subject to federal jurisdiction, such as corporations incorporated under the *Canada Business Corporations Act ("CBCA")*, and financial institutions such as those

incorporated under the *Bank Act*, the *Trust Companies Act*, and the *Insurance Companies Act*:

> **The Court shall in awarding damages for negligence relating to the issuance of financial information by an organization, apportion such damages according to the fault of each defendant and their liability shall not exceed their proportion of the fault.**

The accounting profession is proposing that each province adopt similar legislation for organizations subject to provincial jurisdiction. Each province provides for the incorporation of business corporations and financial institutions such as trust companies, loan companies, and insurance companies. Such provincial organizations are just as susceptible to business failure as their federal counterparts and we believe that joint and several liability should be eliminated, in this very narrow area of the law, on a province-by-province basis.

The real threat to the accounting profession is at the federal level, and it is imperative that legislative action be taken federally without awaiting provincial reform. All but one of the corporations mentioned in the section "II. Claims Against Auditors in Canada" were incorporated under federal statutes and are subject to federal jurisdiction. We are not suggesting, however, that the amendment proposed above would have any application to any of them. The amendment would have no retroactive effect.

This proposal follows the direction of legal and regulatory thought in this country. An interim report issued in December 1995 by the Toronto Stock Exchange Committee on Corporate Disclosure addressed the joint and several issue as follows: "... This issue required little debate by the Committee. In the United States model, one of the clearest incentives to the entrepreneurial plaintiff or attorney is the opportunity to recover from "deep pockets" provided by a system that imposes joint and several liability. ... We strongly believe this approach is inappropriate in Canada because it risks unfairly prejudicing defendants who have little responsibility for a misrepresentation or delay but substantial ability to pay."

The Committee went on to "... recommend that each defendant should be liable only for such defendant's proportionate share of the damages awarded to the plaintiff, *unless* the plaintiff establishes that the defendant *intentionally* made the misrepresentation ..." in which case, the Committee recommended, all the defendants should be jointly and severally liable for damages awarded. To make their report abundantly clear, the Committee expanded on this point: "By proportionate share we mean the portion of total damages that corresponds to the defendant's proportion of the fault assessed by a court."

Both in Canadian studies and in Congressional action in the United States, this rule of joint and several liability has been seen as a form of punishment in the civil law. The principle of proportionate liability is believed to be founded on fairness.

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